RockCreek

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CHINA: WHERE DO INVESTORS GO FROM HERE?

Soon after the Chinese Communist Party's 100th birthday celebration on July 1, abrupt changes by regulators in the rules governing the education sector led to a sharp market correction in the new economy and tech sectors listed in Hong Kong and the United States. In line with the Chinese government focus on "common prosperity", specific sectors viewed as becoming unaffordable to the masses—namely housing, healthcare, and education—came under increasing regulatory scrutiny.

Global investors struggled to digest the rapidly evolving regulatory developments that seemed to involve a widening number of industries and sectors. Combined, they have led many investors to conclude that no sector in China is safe from the whims of policymakers. Some investors believe that Chinese leaders are more clearly redefining the relationship between technology, society, and politics; however, others worry that politicians are testing unproven policies without clear direction and certainty that it will work.

In the wake of these developments, many investors are closely watching the Chinese market and staying on the sidelines. Several large banks and asset managers believe that China will continue to offer strong investment opportunities, while others, such as George Soros (who has been openly negative on China for a number of years), warn American investors about the risks of putting their money in China.

This paper lays out several issues that investors should bear in mind as they decide their future course of action regarding investing in China. More specifically, it concludes that the level of uncertainty related to investing in China has gone up with implications for returns and liquidity.

Critical Issues

First, ever since Xi Jinping became Chinese president nine years ago, he has consolidated power, and today he is China's most powerful leader in decades. Many of his actions since 2012 have won him widespread public support in China, including attacking corruption, reducing poverty, and projecting Chinese military strength. The National People's Congress removed the two-term limit on the Chinese presidency in 2018, thereby allowing him to remain in power for life. President Xi Jinping's priorities in 2022 and beyond are focused on reducing wealth inequalities through a program of 'common prosperity', a crowd pleaser that will help him consolidate support from the bottom 80 percent of the population on the social-economic scale.

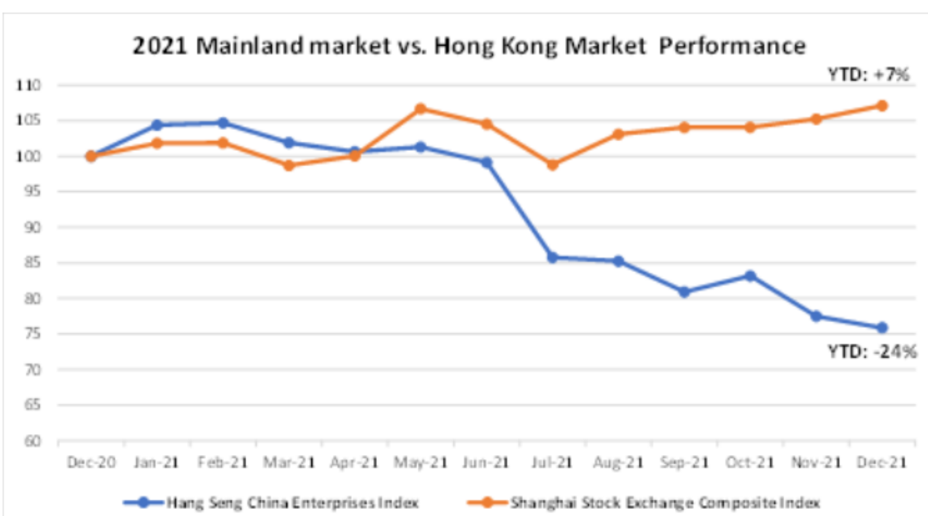
Second, even before Xi, the Chinese government has always played a dominant role in the Chinese economy. China has been a socialist country since 1949, and for more than seven decades the central government has been involved in shaping economic activity, either through regulation or direct ownership. The reforms ushered in by Deng Xiaoping led to profound changes in China's economy. China opened up to the global economy, eventually joining the World Trade Organization, foreign investors were allowed in some sectors, and free enterprise flourished.

As China's economy modernized and grew rapidly in subsequent decades, lifting hundreds of millions of Chinese out of poverty, the state nevertheless maintained ultimate control. To the frustration of the United States and other trading partners, the country did not move to a fully market-based system. Its leadership simply opted not to exercise control in a heavy-handed manner because market forces had not interfered with policy goals – until they did.

The events that unfolded this year, in essence, are the government views that the market-oriented approach in some unsupervised sectors, such as the after-school tutoring industry, have generated overwhelming, unintended long-term social consequences (for example, there is a significant decline in birth rates as young couples simply believe they will not be able to afford to have a family given the heavy burden of housing, education, and healthcare). The government has now decided to implement measures to address them.

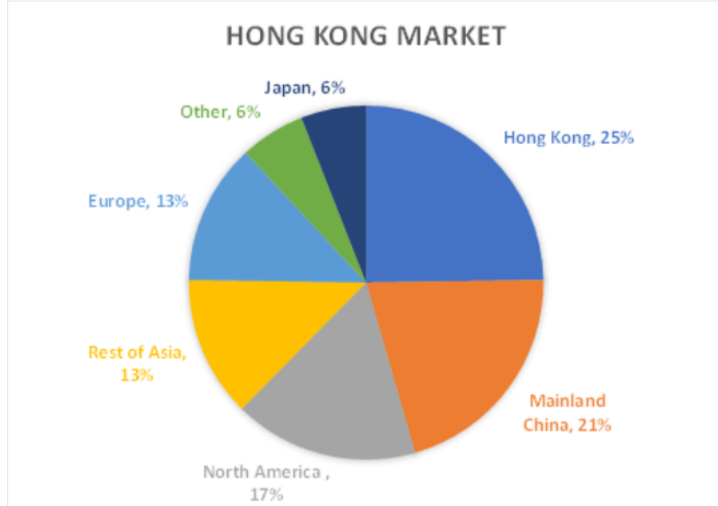
Domestic investors are familiar with the role of the state and have always understood that "whatever the Chinese state wants, the Chinese state gets." In their minds, the 'paradigm shift' seen by some in the Western Media exaggerates the changes under Xi. However, some domestic investors have also been taken aback by the harshness of recent decisions and the abruptness of the execution. Broadly, they understand that investing in China will involve living with unpredictable regulatory actions, but the level of unpredictability has gotten harder in recent years. Foreign investors, in contrast, are unused to dramatic and seemingly capricious government interventions with the ostensible aim of maximizing social good.

For these investors it is, therefore, understandable that there is heightened sense of discomfort when edicts rain down from Beijing. This is reflected in a significant divergence of 32 percent between the mainland and Hong Kong markets in 2021 – a divergence that picked up steam in June as the reform agenda unfolded.



Source: RockCreek

Investor Base Breakdown by Region for Mainland and Hong Kong Markets



Source: RockCreek, JPMorgan

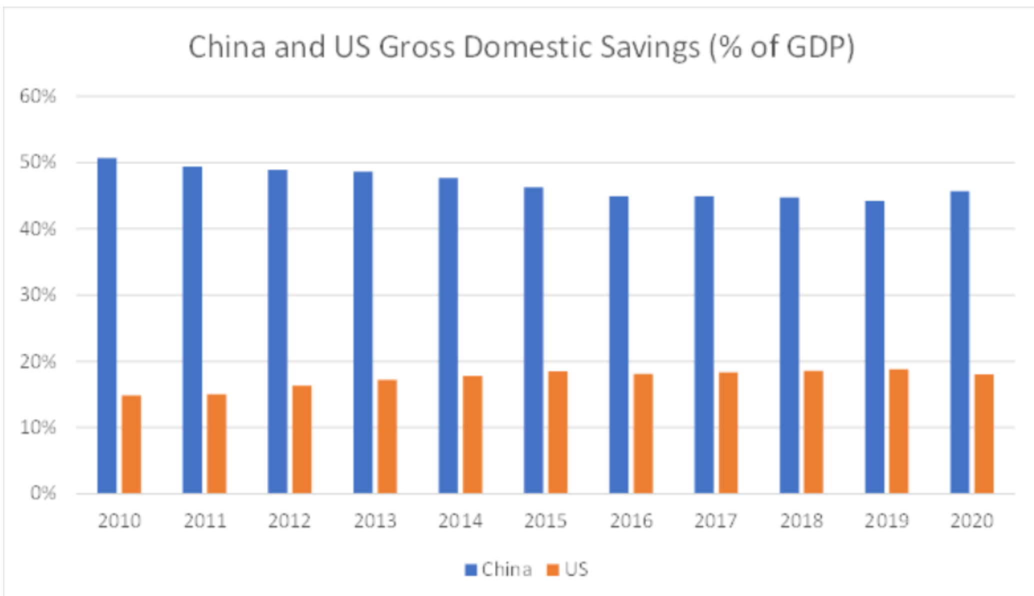
The reason mainland investors are relatively more comfortable with the current environment is they believe the Chinese leadership understands very well that political stability is built on economic stability. They are also very familiar with having to adapt to government intervention in all aspects of life, from the historical One-Child Policy to sudden lockdowns during the ongoing pandemic. Although there are continuing debates about the overall growth rate needed to ensure this political stability, mainland investors do not believe that the government will implement policies that result in economic stagnation. In line with these expectations, we have seen more accommodating economic policies being rolled out in recent weeks.

Even though we have seen a series of regulatory actions related to the education, healthcare, e-commerce, media, entertainment, and gaming industries, we have also seen many other industries benefiting from more favorable policy support or enjoying stronger growth environments. With the support of the government's green infrastructure policies, China is already the world's largest market for electric vehicles, representing more than 40 percent of worldwide EV sales. Four out of the world's top 10 largest EV battery makers are Chinese companies, which combined represent over 44 percent of the global market share. Other sectors where we have seen continued strong policy support accompanied by meaningful capital inflows this year include the semiconductor, pharmaceutical, and healthy-living sectors.

Third, contrary to some predictions that 2022 will likely turn out to be a quiet year between the United States and China, we believe US-China tensions will only escalate in 2022 and beyond. Both countries' media have been quite negative on their respective reporting on the other country for several years. Although the United States' reporting on China has been predominantly negative, it is worth noting that reporting from China focuses on 'foreign forces' seeking to curb China's rise as a great nation. This has helped exacerbate a broad and elevated distrust in the respective populations that will bias the political and economic environments for investing. In China last year, "support for national brand and boycott of US brand" hugely benefited domestic companies from sport brands Li Ning to local restaurant chains. This became one of the hottest investment themes in both public and private markets. This month, people are boycotting Walmart in China because the discount retail chain discontinued carrying dry fruits out of the Xinjiang region, a hugely popular product among Chinese consumers, due to US regulations banning imports from Xinjiang. In the United States, as we move closer to the 2024 Presidential Election, there is very little doubt that, no matter the outcome, there will continue to be a tough stand on China.

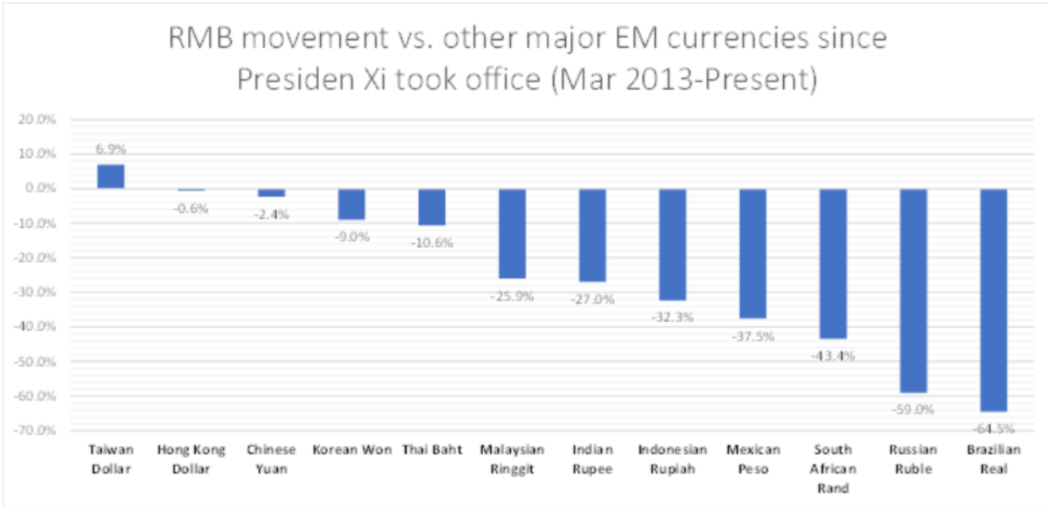
Lockdowns and Leverage

There may be a small chance that the country's Zero-Tolerance Covid policy could change before the 20th Party Congress; however, it is very likely that 2022 will be a repeat of 2021, with multiple rounds of strict local lockdowns and re-openings. Chinese household consumption behavior continues to be affected by this policy, which is not helpful in building up consumer confidence. The zero-tolerance policy is also likely to interfere with supply chains and prolong global supply problems. The current property downturn is expected to continue into a multi-year slowdown period, as the post-Covid rebound fades, lending policy tightens, and Evergrande's troubles continue. We believe some developers will continue to face a difficult time this year, and property activities will continue to trend down in the coming years; however, the ongoing government-led deleveraging of the property market, if handled well, would remove a major risk to the Chinese economy and help the country settle into slower but more resilient growth in the perceivable future.



Source: RockCreek, World Bank

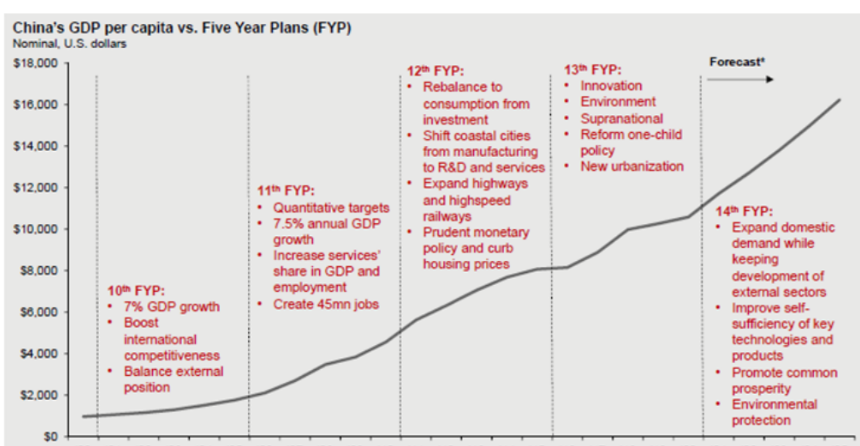
From a currency standpoint, Chinese RMB has been largely stable vs. USD since Xi took office in March 2013. This is consistent with the leaderships' view of what a strong currency represents – the RMB, being a store of value, can challenge the USD as a medium of exchange in global markets. Despite the turmoil the Hong Kong and ADR markets experienced in 2021, the Chinese RMB appreciated by 2.6 percent over the course of the year. Elevated goods, a trade surplus, and favorable interest spread between China and the rest of the world brought strong inflows into the currency, despite the regulatory concerns. Going forward, we expect the RMB to reverse modestly in 2022 but remain stable in the foreseeable future. Normalization of monetary policy in the west will make the interest rate spread less attractive between China and rest of the world and improvement of supply chain disruptions in the coming years will also narrow the trade surplus for China. On the other hand, the Chinese currency will be supported by more foreign purchases of RMB bonds as the global FI managers continue to diversify their portfolios. We also expect interest rates to remain stable after the 10bps January rate cut by PBOC with the easing policy more targeted towards green capex and SMEs.



Conclusion

There is little doubt we are in a world run by two distinct systems. Despite reservations investors may have towards the Chinese political system, there is consensus that China will be an important economic entity in the world, one that is intricately linked to global trade flows, with a market exchange rate GDP that could be equal with that of the United States within the next 10 years. China will remain a deep, important, and growing market, even though it has been, and will continue to be, run under a one-party system. Xi believes that his ‘common prosperity’ policy goals aim to broaden China’s ‘middle class’ and double the country’s GDP per capita by 2035. This has been the same economic goal that has driven Chinese policy over the last decade, as the government has moved to promote higher domestic living standards based on a dynamic domestic economy, rather than simply relying on exports to sustain rapid growth.

The Chinese government emphasized again last week that China needs to “get the pie bigger first” and then “distribute the pie more equally” to achieve common prosperity. In addition, Xi reiterated China’s committed to reform and opening-up in this week’s 2022 Devos Forum: “For China, reform and opening-up is always a work in process,” he said. “China will continue to let the market play a decisive role in resource allocation and see to it that the government better plays its role. We will be steadfast in consolidating and developing the public sector, just as we are steadfast in encouraging, supporting, and guiding the development of the non-public sector. We will build a unified, open, competitive and orderly market system, where all businesses enjoy equal status before the law and have equal opportunities in the marketplace."



Source: IMF, JPM, RockCreek

The question remains whether Xi's political strategy and leadership style will prove to be a benefit or hindrance to the execution of his economic ambitions for the country. To a large extent, that is the source of the key concerns about China expressed by investors: they worry that there have been few examples of a highly authoritative government, with relatively little accountability, delivering stable growth over a long period of time.

For those who decide to continue to invest and participate in China, there will be a need to monitor, analyze, and react to political developments than has been required over the last three decades. There is also a requirement to react more quickly than before, and as such, investment liquidity is a key issue. In short, the current environment is significantly more difficult for asset classes that require longer lock up periods, such as private equity. Investors will have to recalibrate and decide for themselves how to handle the increased uncertainty in the Chinese markets and, in turn, their comfort level with reduced liquidity.

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